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**USTA****United States Telephone Association**900 19th Street, N.W., Suite 800  
Washington, D.C. 20006-2105  
(202) 835-3100

November 19, 1992

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Ms. Donna R. Searcy  
Secretary  
Federal Communications Commission  
1919 M Street, N.W. - Room 222  
Washington, D.C. 20554

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

RE: **Ex Parte Meeting**  
**CC Docket No. 92-101**

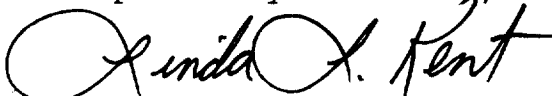
Dear Ms. Searcy,

On November 18, 1992, R.T. Gregg, Jeff Olson, Richard Lawson, Gill Johnston, and Marie Johns, representing the United States Telephone Association (USTA), met with Kathleen Abernathy of Commissioner Marshall's office, Linda Oliver of Commissioner Duggan's office, Charla Rath of Chairman Sikes' office, Lauren Belvin of Commission Quello's office, and Madeline Kuchera of Commissioner Barrett's office.

The purpose of the meeting was to discuss SFAS 106 and OPEBS, a matter that is currently at issue in the above-captioned proceeding. The points made by USTA are already reflected in its comments on file in this proceeding. Any document left with the Commission is being submitted for the file with this ex parte letter.

The original and one copy of this notice are being filed in the Office of the Secretary on November 19, 1992 due to the lateness of the meeting. Please include a copy in the public record.

Respectfully submitted,



Linda L. Kent  
Associate General Counsel

cc: Kathleen Abernathy  
Linda Oliver  
Charla Rath  
Lauren Belvin  
Madeline Kuchera

Mr. [unclear] 04/10  
[unclear]

## **Exogenous Treatment of Incremental SFAS 106 Costs USTA Ex Parte in CC Docket No. 92-101**

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FEDERAL COMMUNICATIONS COMMISSION  
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- Brief Overview of SFAS 106
- SFAS 106 expenses are a real cost of doing business.
  - FASB and the Commission agree.
- The burden of proof established by the Commission. Two additional showings remain (and have been made by LECs on the record):
  1. The incremental costs of SFAS 106 are outside the control of LECs.
    - Mandated by FASB and the Commission.
    - Most of the costs are associated with benefits earned by employees in prior periods.
  2. Only a minuscule portion of added costs are reflected in the GNP-PI.
    - The two LEC studies (Godwins and NERA) have been extensively reviewed and the conclusion is that only a tiny portion is reflected in GNP-PI. Those amounts have already been removed from the LEC exogenous amounts.
- The LEC SFAS 106 costs are reasonable.
  - The SFAS 106 valuations have undergone significant scrutiny.
- Exogenous treatment is consistent with incentives to be more efficient.
  - The LECs are only requesting exogenous treatment of the incremental SFAS 106 costs, using conservative assumptions, including significant further cost savings.
  - If the LECs do not manage their OPEB costs to these conservative assumptions, profitability will suffer.
- Exogenous treatment is not related to funding decisions.
  - The Commission has already concluded that the carrier funding decisions do not apply to the rate recovery decision.

## Brief Overview of SFAS 106

- Statement of Financial Accounting Standards No. 106<sup>1</sup> (SFAS 106) is the statement adopted by the Financial Accounting Standards Board (FASB) regarding accounting for Other Postretirement Employee Benefits (OPEBs). FASB-adopted statements represent changes in Generally Accepted Accounting Practices (GAAP).
  - GAAP is the set of accounting rules and guidelines companies must follow when publicly reporting earnings and financial positions.
  - The Commission's Part 32 Accounting Rules require regulated telecommunications carriers to maintain their financial records in accordance with GAAP.
- OPEBs are benefits other than pensions paid on behalf of retirees. These benefits are primarily medical care, but also include dental care and life insurance.
- SFAS 106 moves from a cash basis to an accrual basis for recording the costs associated with postretirement benefits earned by employees.
- SFAS 106 requires that companies record the cost of these benefits as they are earned by employees, rather than waiting to reflect these costs after employees retire and benefits are received by retirees.
  - Thus, SFAS 106 properly matches the cost of providing OPEBs with when they are earned.




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<sup>1</sup> Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, issued December 1990.

## Description of SFAS 106 Accounting

**Example of a single individual** (based on typical characteristics):

- Hired in 1974.
- Expected to be "vested" for OPEBs in 2000 at 50 years old with 25 years service.
- Expected to retire in 2010 with 36 years service.
- Expected to die in 2028 at age 78.

| <u>Year</u>       | <u>Benefits Accrue</u>  |             |             | <u>Benefits Paid</u> |             |
|-------------------|---|-------------|-------------|----------------------|-------------|
|                   | <u>1974</u>   | <u>1993</u> | <u>2000</u> | <u>2011</u>          | <u>2028</u> |
| Age of Employee   | 24  | 43          | 50          | 61                   | 78          |
| Length of Service | 0   | 18          | 25          | 36                   | —           |
|                   | <div style="text-align: center;">  <br/>TBO         </div>                               |             |             |                      |             |
|                   | <div style="text-align: center;">  <br/>Attribution Period         </div>               |             |             |                      |             |
|                   | <div style="text-align: center;">  <br/>Total Expected Length of Service         </div> |             |             |                      |             |

- Benefits are accrued as earned by employee from the year 1974 through 2000 (the attribution period). Benefits are paid from the year 2011 through 2028.
- The TBO, Transition Benefit Obligation, is the portion of total SFAS 106 costs associated with benefits already earned by employees at the point in time when SFAS 106 accounting is adopted, 1993 in this example. These costs are associated with benefits earned in prior periods. [The TBO associated with this typical employee is approximately 72% (18 years divided by 25 years) of the total present value of past and future expected earned benefits.]

**SFAS 106 expenses are a real cost of doing business.**

- The deliberative process used by the FASB concluded that accrual accounting for OPEBs represents the true economic costs of OPEBs.
  - The 12-year FASB deliberative process included input from economists, actuaries, investment analysts, regulators and most of American industry. SFAS 106 was the result of that extensive deliberation.
- The Commission has already agreed with the FASB and American industry that SFAS 106 costs are appropriate. The Commission concluded that SFAS 106 accounting is consistent with the Commission's regulatory accounting objectives.<sup>1</sup>
- Effective 1-1-93, SFAS 106 will be the generally accepted accounting standard for OPEBs, including price cap LECs.
  - In its December 26, 1991 order, the Commission adopted GAAP accounting for OPEBs for all carriers. Thus, SFAS 106 costs are real costs, recognized as legitimate regulated costs of service in Parts 32 and 65 of the Commission's Rules.
- The Commission had previously concluded that SFAS 106 costs are real costs for both ROR LECs and price cap LECs:

"Our change in regulation, from rate of return to price caps, should not result in our changing the treatment of such (OPEB) costs. While a regulatory change may affect prospective treatment of these expenses, costs and rates that have been accepted as reasonable and prudent under prior standards should not be treated as unreasonable or imprudent merely because our regulations have changed."<sup>2</sup> [emphasis added]

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<sup>1</sup> Order, Southwestern Bell, GTE Service Corporation Notification of Intent to Adopt Statement of Financial Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, AAD 91-80, released December 26, 1991. "After reviewing SFAS-106, we have concluded that its adoption for accounting purposes will not conflict with the Commission's regulatory objectives." para. 3. Further, RAO Letter 20 dictates to all carriers how to remove these "real" SFAS 106 costs from carriers' rate bases if the liability is not funded.

<sup>2</sup> Order on reconsideration, CC Docket No. 87-313, released April 17, 1991, para.62.

- Rate of return carriers are presently being allowed rate recovery of the incremental costs of SFAS 106. (See, for example, in CC Docket No. 92-141 and NECA tariff filings).
- SFAS 106 costs are just as "real" as other accrual and noncash expenses, such as deferred income taxes, pensions and depreciation. The fact that cash outlays do not necessarily occur at the same time as the expense is incurred cannot render these costs any "less real."
- SFAS 106 (just like SFAS 87 regarding pensions) recognizes that an employee earns benefits over the employee's service life and that the company must recognize its costs of providing OPEBs during the same period.
- Accrual accounting is consistent with fundamental ratemaking theory which is premised on the fact that costs and benefits accrue to the generation of customers responsible for the costs or benefits.

**The price cap LECs are requesting exogenous treatment.**

- During the debate over price cap regulation, both LECs and the Commission recognized that the long-pending accrual accounting for OPEBs was a primary (possibly the most significant) example of the need for the exogenous cost adjustment mechanism within the price cap framework.
- The price cap LECs contend that they should be allowed to increase price cap indexes to reflect that the initial price cap rates did not adequately include the true economic costs of OPEBs.
- The majority of the incremental SFAS 106 costs relate to periods prior to the implementation of the LEC price cap plan (January 1, 1991).

**The burden of proof established by the Commission.**

- The LEC Price Cap Order (at para. 168) stated that:

"Changes in LEC costs that are caused by changes in Part 32 of our Rules, the Uniform System of Accounts (USOA), will be considered exogenous." (emphasis added)

- Subsequently, the Commission decided to issue an interpretation of existing rules rather than revise its Part 32 (and Part 65) rules in the Order that required all carriers to adopt SFAS 106 and the following RAO Letter that provided guidance on accounting.<sup>1</sup>

"No GAAP change can be given exogenous treatment until the Financial Accounting Standards Board has actually approved the change and it has become effective."

- The FASB has now approved SFAS 106 and that change will become effective no later than 1-1-93.
- The AT&T Price Cap Order on Reconsideration (at para. 75) stated:

"GAAP changes should be eligible for exogenous treatment after a case-by-case review indicates that the change will not be adequately reflected in the GNP-PI."
- It is exactly this showing that the price cap LECs have made in their Direct Cases filed June 1, 1992 and Rebuttals filed July 31, 1992.

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<sup>1</sup> Order, released December 29, 1991, AAD 91-80 and RAO Letter 20, released April 24, 1992.

- The LEC Price Cap Order on Reconsideration (at paras. 61 and 62) stated:

"Carriers that chose to accrue OPEB expenses were no more 'right' or 'wrong' than carriers that chose to await the GAAP change."

"Carriers that elected to wait until the GAAP change becomes effective before expending funds for OPEBs are not necessarily foreclosed from recovering those costs."

- Granting the exogenous amounts in the Direct Cases in this docket assures an equitable opportunity for recovery of the price cap LECs' incremental SFAS 106 costs.
- Thus, by its prior orders, the Commission has established that the record must now sustain positive ruling in two remaining areas for the Commission to allow the incremental SFAS 106 costs to be exogenous:
  - These costs are outside the control of the LEC,<sup>1</sup> and;
  - The costs are not already recovered due to operation of the price cap formulas (i.e., not reflected in the GNP-PI inflation measure).

**The incremental costs of SFAS 106 are outside the control of LECs.**

- The price cap LECs do not control the mandate to implement SFAS 106 on their financial or regulated books. Both the FASB and the FCC require SFAS 106 accounting.
- For a given group of employees and retirees and given benefit plans, the incremental costs of SFAS 106 are known and measurable (determined by actuarial study, just like is done now for pensions, SFAS 87).
  - LEC actuarial valuations have numerous interrelated calculations that cannot be arbitrarily changed without rendering the subsequently modified SFAS 106 valuation invalid.
  - AT&T accepts that exogenous treatment is appropriate, but suggests flawed revisions to the LEC actuarial valuations that would reduce the exogenous amounts. [USTA has responded to all AT&T suggestions.]

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<sup>1</sup> LEC Price Cap Order, para. 166.



- The vast majority of SFAS 106 costs are associated with benefits earned by employees in prior periods. Price cap LECs have little ability to "control" or alter level of benefits earned in prior periods. The LECs do, however, have plans in place to control the future costs of these benefits.
- The SFAS 106 valuations are reduced by the fact that some employees leave the company before becoming eligible to receive benefits.

**Only a minuscule portion of added costs are reflected in the GNP-PI.**

- Both the Godwins study and the NERA study clearly reveal that only a minuscule portion of the incremental LEC costs caused by SFAS 106 are reflected in the GNP-PI.
  - Both studies were reviewed by the California Commission.
  - The proposed California order concludes that both studies produced similar credible results and states that the Godwins study is very conservative.
- The Godwins study was extremely conservative in nature. Conservative in this sense means that all assumptions in the Godwins study were chosen so that it overestimates the extent that SFAS 106 costs are captured in the GNP-PI.
- The NERA approach, though different, is very tractable and reasonable. It yields similar results -- that the incremental costs of SFAS 106 are not recovered through changes in the GNP-PI.
- Thus, based on the reductions to the exogenous amounts requested by the price cap LECs, there is no remaining double counting of SFAS 106 costs occurring from exogenous cost treatment requested and price cap formula, which includes GNP-PI . Therefore, the price cap LECs have satisfied the second of the remaining "tests."

**The LEC SFAS 106 costs are reasonable.**

- SFAS 106 costs are calculated in compliance with the FASB rules and are based on sound, well-accepted actuarial principles.
- These costs are subject to the scrutiny of independent auditors (the SFAS 106 costs are auditable), and the SEC and shareholders/investors (through disclosures and financial reports). SFAS 87 regarding pension expense requires a similar methodology.
- SFAS 106, like SFAS 87, requires each company to reflect company-specific information in its valuation. Because of differences in company demographics, benefit plans and experience, a simplified set of standard assumptions is not appropriate.

**Exogenous treatment is consistent with incentives to be more efficient.**

- The price cap LECs do not look to exogenous treatment for SFAS 106 as a replacement for cost containment.
  - The SFAS 106 valuations contains conservative assumptions, including significant further cost savings.
  - If the LECs do not manage their OPEB costs to the conservative assumptions contained in their valuations, profitability will suffer.
  - There is no reduction in the incentives to be more efficient.
- The LEC exogenous amounts only include the incremental SFAS 106 costs.
- The price cap LECs are simply requesting an opportunity to recover legitimate costs of doing business.

**Exogenous treatment is not related to funding decisions.**

- Recommendations that the exogenous amounts be tied somehow to amounts that the LECs fund have no merit.
- On this same issue, relating to pensions (SFAS 87), the Commission has already concluded that funding is completely separate from rate recovery.<sup>1</sup>
- Any requirement that rate recovery be tied to funding decisions will insert the Commission into the LECs' cash management operations with potentially uneconomic consequences.
  - The decision on the extent of funding is an economic decision based on available investment choices. These choices include: tax deferred trusts that allow the accumulation of tax-free earnings (if available); non-tax-deferred trusts or investments; reinvestment in the company. The decision on which choices should be selected is based in economics. In each case, however, there will be funds available for retirees' OPEBs when cash outlays are made.
  - The availability of tax-advantaged funding vehicles for OPEBs will determine the extent to which immediate funding of the full SFAS 106 costs is a wise short-term use of cash. Cash management should not be mandated by the Commission.
- The accounting treatment of SFAS 106 costs ensures that customers are protected. If the carrier does not immediately fund the full SFAS 106 costs, there is a mandated reduction in the rate base.
  - RAO Letter 20 provides this customer protection. Further regulations regarding funding of SFAS 106 costs would be inconsistent with the ratemaking principles that have been applied to other accrual accounting costs (such as deferred income taxes and pensions).
- The intent of price cap regulation is let economic incentives drive decisions. The OPEB funding decision is no different!

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<sup>1</sup> Report and Order, Revision of USOA, CC Docket No. 84-469, released November 14, 1985 (GAAP Order). "We see no need to review the pension costs being booked by carriers in accordance with GAAP, and we will allow carriers to book unfunded pension expenses which are actuarially determined in the revised USOA." para. 93.